

**STATE OF NORTH DAKOTA  
BISMARCK, NORTH DAKOTA**

**REPORT OF EXAMINATION**

**OF**

**INDIAN HARBOR INSURANCE COMPANY  
STAMFORD, CONNECTICUT**

**AS OF  
DECEMBER 31, 2002**

STATE OF NORTH DAKOTA  
DEPARTMENT OF INSURANCE

I, the undersigned, Commissioner of Insurance of the State of North Dakota do hereby certify that I have compared the annexed copy of the Report of Examination of the

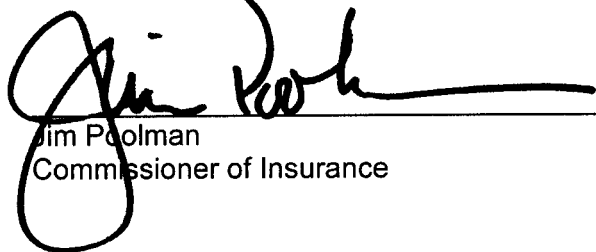
**Indian Harbor Insurance Company**

**Stamford, Connecticut**

as of December 31, 2002, with the original on file in this Department and that the same is a correct transcript therefrom and of the whole of said original.



IN WITNESS WHEREOF, I have hereunto  
set my hand and affixed my official seal at my  
office in the City of Bismarck, this 7<sup>th</sup> day of  
October, 2005.

  
Jim Poolman  
Commissioner of Insurance

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Stamford, Connecticut  
July 30, 2005

Honorable Alfred W. Gross  
Chair, Financial Condition (E) Committee, NAIC  
Commissioner, State Corporation Commission  
Bureau of Insurance  
Commonwealth of Virginia  
P.O. Box 1157  
Richmond, VA 23218

Honorable Jorge Gomez  
Secretary, Midwestern Zone  
Commissioner, Office of the Commissioner of Insurance  
State of Wisconsin  
125 South Webster Street  
GEF III – 2<sup>nd</sup> Floor  
Madison, WI 53702

Honorable Jim Poolman  
Commissioner of Insurance  
North Dakota Department of Insurance  
600 East Boulevard  
Bismarck, ND 58505-0320

Commissioners:

Pursuant to your instructions and statutory requirements, a financial examination has been made of the books, records, and financial condition of

**Indian Harbor Insurance Company**

**Stamford, Connecticut**

hereinafter referred to as the "Company." The examination was conducted at the Company's main administrative office located at Seaview House, 70 Seaview Avenue, Stamford, CT. The Company was last examined as of December 31, 1999, by the North Dakota Insurance Department. The report of examination is herein respectfully submitted.

**SCOPE OF EXAMINATION**

This examination was a financial condition examination conducted in accordance with N.D. Cent. Code § 26.1-03-19.3 and observed guidelines and procedures contained in the National Association of Insurance Commissioners (NAIC) *Financial Condition Examiners Handbook*. The examination was conducted to determine the Company's financial condition, its compliance with statutes, and to review its corporate affairs and insurance operations. This statutory examination covers the three-year period from January 1, 2000, to and including December 31, 2002, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of this statutory examination.

Work papers provided by the Company's independent auditor, PriceWaterhouseCoopers, L.L.P., were reviewed and where deemed appropriate certain procedures and conclusions documented in those work papers have been relied upon and copied for inclusion into the working papers for this examination.

This examination was conducted by an Examiner contracted by the North Dakota Insurance Department, representing the Midwestern Zone.

## **PRIOR EXAMINATION COMMENTS**

### **Recommendation**

It is recommended that the Company comply with strict adherence to the requirements for Managing General Agents as provided in N.D. Cent. Code Chapter 26.1-26.3. It is recommended that the Company disclose the MGA direct premium written in Footnote 25 of the Notes to Financial Statements.

It is recommended that the Company obtain and retain proper authorizations of reinsurance intermediary-brokers that satisfy the requirements of N.D. Cent. Code § 26.1 -31.1-03.

It is recommended that the Company obtain fully executed contracts within nine months of establishing a new reinsurance program.

It is recommended that the Company and its affiliates establish procedures to insure that the reinsurance balances and transactions reported by the Company in Schedule F agree with the amounts reported by affiliates.

### **Action by the Company**

The current examination noted two Managing General Agents as defined under N.D. Cent. Code Chapter 26.1-26.3 that were not reported to the department as required and one MGA that was not disclosed in Footnote 25 of the Notes to Financial Statements. The Company did obtain audited financial statement as required and conducted at least one review of claims and underwriting. However, the statute says that such reviews shall be no less than semi-annually. The Company should keep adequate records to document that nature of the review and any findings. These reviews should be retained and made available for examination.

**It is again recommended that the Company comply with the requirements for Managing General Agents as provided in N.D. Cent, Code Chapter 26.1-26.3.**

The gross pooling effectively shifted the reinsurance intermediary function to XL Reinsurance America, the pool leader. Therefore, compliance with this recommendation was not reviewed.

Reinsurance is now handled by XL Reinsurance America as part of the gross reinsurance pooling agreement effective January 1, 2002. The Company is considered in compliance with this examination comment.

The Company is in compliance with this recommendation.

### **Recommendation**

It is recommended that the Company maintain sufficient documentation supporting year-end accruals.

It is recommended that the Treaty and Retrocession amounts be correctly posted to the appropriate worksheet and that the current balances in the roll forward worksheets be corrected to reflect accurate balances.

It is recommended that the Company non-admit the agents balances amount for balances over 90 days past due and report premiums that have been booked but are not yet due separately on page 2, line 10.2, of the annual statement.

It is recommended that the Company post the unearned premium reported by the MGA on the bordereau if it is larger than that calculated by RSG.

It is recommended that the Company incorporate the accounting for reinsurance recoverables in its closing schedule and that management monitor the closing schedule to ensure that all accounts have been processed regardless of turnover or extended absences.

It is recommended that the Company develop control procedures to ensure that all open claim reserves are included in the reserve inventory.

### **Action by the Company**

The Company is in compliance with this recommendation.

Reinsurance transactions are now handled by XL Reinsurance America as part of the pool's conversion to a gross basis in 2002. A review of retrocessions by the New York Insurance Department did not indicate that such problems still existed.

The Company only records reinsurance estimated premiums as booked and deferred and not yet due, although the examination noted that the Company has insurance balances that are on an installment basis and should also be included in line 10.2. The Company accounted for balances 90 days past due but did so incorrectly: balances were netted with unrelated brokers; balances contained credit amounts and were calculated on accounting due date and not policy effective date; and reinsurance payable amounts were offset against the over 90 day amounts.

**It is again recommended that the Company non-admit the agents' balances amounts over 90 days past due and report premiums that have been booked but are not yet due separately on page 2, line 10.2, of the annual statement.**

The Company is in compliance with this recommendation.

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The Company is in compliance with this recommendation.

### **Recommendation**

It is recommended that the Company report money market fund balances in Schedule DA as required in the *Annual Statement Instructions*.

### **Action by the Company**

The *Purposes and Procedures Manual of the SVO*, under Part 4, Section 9(d), classifies money market funds as common stock unless the fund is listed in Sections 8, 9 or 10 of the Manual's Appendix. The Company incorrectly reports money market funds as Cash on Schedule E, whereas the funds are included in the Section 9 listing of Class 1 Funds and should be reported on Schedule DA.

**It is recommended that the Company report money market fund balances in accord with the *Purposes and Procedures Manual of the SVO*.**

## **HISTORY**

### **General**

The Company was incorporated on June 23, 1992, under the laws of the State of North Dakota. The primary purpose for the Company's formation was to engage in the business of property and casualty insurance. The Company is a wholly owned subsidiary of XL Reinsurance America, Inc. On June 18, 1999, XL Capital Ltd. transacted a stock merger with NAC Re Corporation, the Company's upstream parent. XL Capital Ltd. is a Cayman Island domiciled corporation whose stock is publicly traded on the New York Stock Exchange.

### **Capital Stock**

The Company's Articles of Incorporation authorize the Company to issue 50,000 shares of common capital stock with a par value of \$100 per share. At December 31, 2002, the Company had issued all 50,000 shares to its parent XL Reinsurance America, Inc. (XLRA). Subsequently, on June 30, 2003, XLRA contributed all the outstanding shares of the Company to XL Specialty Insurance Company.

### **Dividends to Stockholders**

During the period under examination, there were no dividends declared or paid.

### **Board of Directors**

The Bylaws provide that the number of directors shall be established by the Board of Directors but shall not be less than seven. Directors shall be elected at the Annual Meeting of the stockholders and each director shall serve until his successor is elected and qualified.

Directors serving at December 31, 2002, were as follows:

<b><u>Name and Address</u></b>	<b><u>Business Affiliations</u></b>
Nicholas M Brown, Jr New Canaan, CT	Chairman of the Board, President, and CEO XL Reinsurance America, Inc.
Richard S. Banas Lexington, KY	Senior Vice President XL Reinsurance America, Inc.
Martha G. Bannerman Greenwich, CT	Executive Vice President, Secretary & General Counsel XL Reinsurance America, Inc.
Lee L. Bennett Woodstock, MD	Senior Vice President XL Reinsurance America, Inc.
Celia R. Brown Rye Brook, NY	Senior Vice President and Assistant Secretary XL Reinsurance America, Inc.
Janet E. Duncan West Hartford, CT	Senior Vice President XL Reinsurance America, Inc.
Richard H. Miller New Fairfield, CT	Senior V.P., Chief Financial Officer and Treasurer XL Reinsurance America, Inc.
Theresa M. Morgan White Plains, NY	Senior Vice President and General Counsel XL Reinsurance America, Inc.
Sean F. Murphy Darien, CT	Senior Vice President XL Reinsurance America, Inc.

### **Officers**

The Bylaws provide that the elected officers of the Company shall be a Chairman of the Board, a President, one or more Vice Presidents, a Treasurer, and a Secretary. Officers serving at December 31, 2002, were as follows:

<b><u>Officer</u></b>	<b><u>Title</u></b>
Nicholas M. Brown, Jr.	Chairman of the Board, President and CEO
George G. Carino	Senior Vice President and Treasurer
Theresa M. Morgan	Senior Vice President, General Counsel & Secretary
Richard S. Banas	Senior Vice President
Charles F. Barr	Senior Vice President and Assistant Secretary
Lee L. Bennett	Senior Vice President
Brian M. Boornazian	Senior Vice President
Celia R. Brown	Senior Vice President and Assistant Secretary
Christopher F. Buse	Senior Vice President
Richard T. Corbett, Jr.	Senior Vice President
Gregory A. Douglas	Senior Vice President
Janet E. Duncan	Senior Vice President



Jeffrey S. Lejfer  
Richard H. Miller  
Thomas W. Muller  
Douglas L. Olsen  
David B. Porteus  
Laura A. Shanahan

Senior Vice President and Assistant Secretary  
Senior Vice President  
Senior Vice President  
Senior Vice President  
Senior Vice President  
Senior Vice President

### **Conflict of Interest**

The Company has established procedures for the disclosure of possible conflicts of interest. Once a year, all directors, officers, and key employees are asked to complete and sign a conflict of interest questionnaire. The signed questionnaires are reviewed by the General Counsel. The conflict of interest statements for 2002 were reviewed and no undisclosed conflicts of interest were observed during the examination which were not disclosed.

### **Corporate Records**

There were no changes noted in the Company's Articles or By-laws during the period under examination.

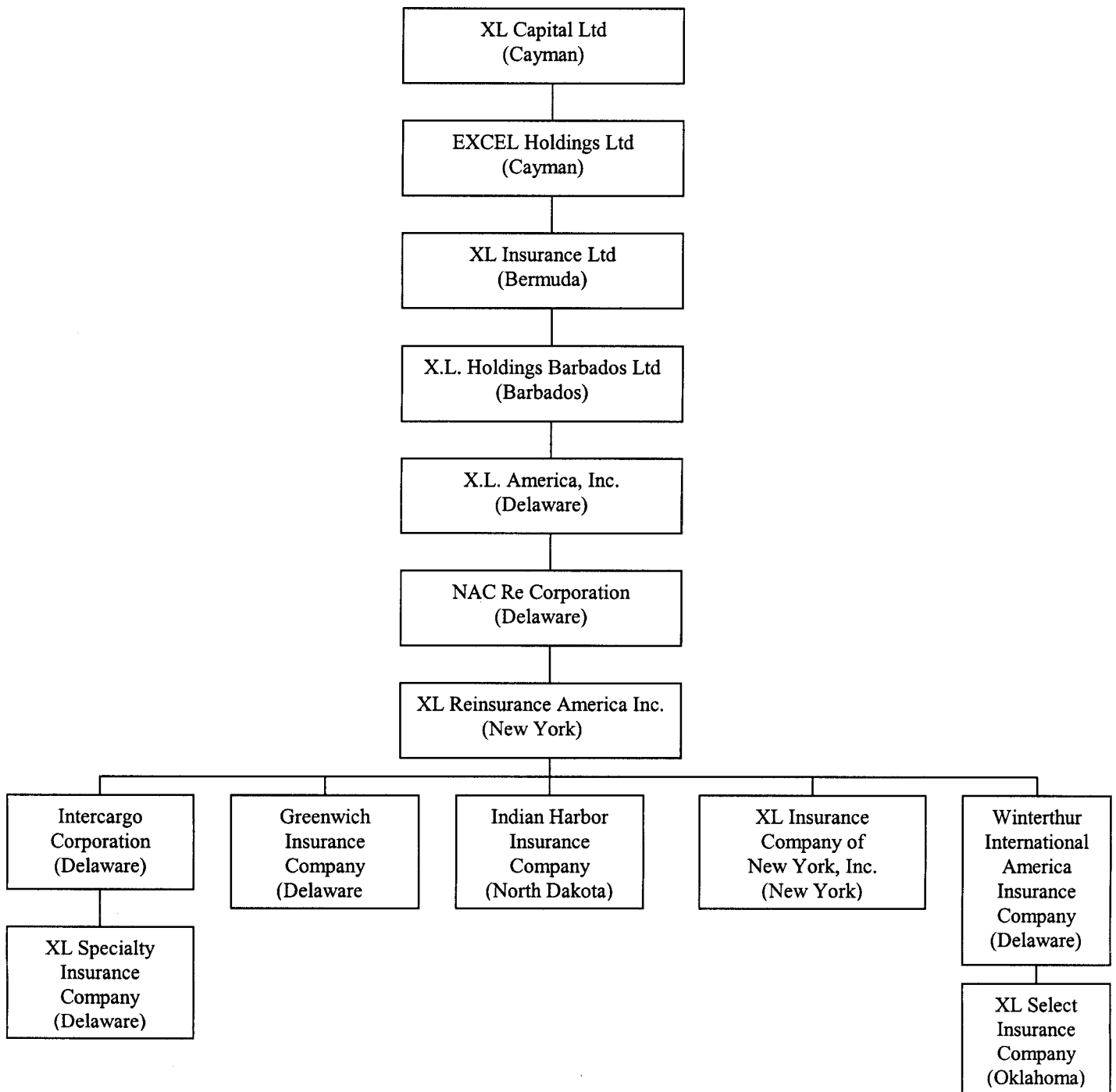
### **Board of Directors and Stockholders**

The minutes of the Board of Directors and stockholders for the period under examination were read. The minutes of the various meetings indicate that meetings were well attended and held in accordance with the Bylaws. The deliberations of the bodies were adequately documented. The Board of Directors approved the prior Report on Examination.

## **AFFILIATED COMPANIES**

### **General**

The Company is wholly owned by XL Reinsurance America, Inc., a New York corporation. The holding company structure as of December 31, 2002, is depicted in the following chart:



## **Intercompany Agreements**

### **General Services Agreement**

Effective April 1, 2001 and as amended July 1, 2001, the Company entered into a general services agreement with XL America, Inc., XL Reinsurance America Inc. (XLRA), the Company's direct parent, and various affiliates. A summary of the agreement follows:

- XL America, Inc. shall make available to the Company the following services: legal counsel, personnel, data processing, office management and supply, administrative, actuarial, accounting, auditing, claims, investment and managerial, and office space related to the conduct of such services. Such services are to be provided on a cost basis.
- XL America, Inc. shall bill the Company for services quarterly with payment due thirty days after receipt of the quarterly report covering all items and incurred charges.

As part of the examiner's expense review a copy of the reports for 2002 were requested. The Company indicated that no such reports existed and that the detail of actual charges could not be ascertained because of the way intercompany expenses are pooled. Charges are determined based on allocations of overhead amounts incurred from NAC Re Corporation, XL America, Inc. and XL Global Services. These amounts are then allocated to XLRA for reinsurance-related expenses and Greenwich Insurance Company for insurance-related expenses. The insurance-related expenses are then allocated to each legal entity according to the provisions of the pooling agreement.

**It is recommended that the allocating entities comply with the Amended General Services Agreement and provide the detail reports as specified on a quarterly basis and that settlements of the charges occur 30 days thereafter.**

### **Tax Allocation Agreement**

The Company along with other members of the X.L. America, Inc. group files a consolidated federal income tax return pursuant to the terms of a tax allocation agreement, effective September 1, 2000, and as amended April 1, 2001, and July 1, 2001. The members of the group agree to pay an amount equal to the federal income tax liability which such member would have incurred if such member had filed a separate federal income tax return.

For each estimated tax period of any year, the estimated federal income tax liability of each member shall be determined and shall be paid within 10 days of receipt of notice. The final amount required to be paid for any taxable year shall be paid on or before the date on which the consolidated return of the group is required to be filed determined without regard to any extension of time to file.

### **Service Agreement**

The Company entered into a service agreement with ECS Underwriting, Inc., dated December 1, 1999, whereby ECS Underwriting was appointed underwriting manager to solicit, underwrite, bind, issue and service policies; and collect premiums for all lines relating to environmental accounts, environmental coverages, and middle market property and casualty lines. Premiums, net of expense and compensation shall be payable within 45 days after month end.

#### Claim Services Agreement

The Company entered into a claims services agreement with ECS Claims Administrators, Inc., effective September 15, 2000. ECS is reimbursed based on direct costs and expenses incurred in performing its duties pursuant to the agreement.

#### General Services Agreement

The Company entered into a general services agreement effective July 1, 2001, with XL Global Services, Inc., X.L. America, Inc. and various affiliates that calls for XL Global Services to provide information, technology, reinsurance, actuarial and other services to the XL Capital Ltd. companies. During the period under examination, no charges were billed to the Company from XL Global Services pursuant to this agreement.

Intercompany reinsurance arrangements are discussed under the Reinsurance section below.

### **FIDELITY BOND AND OTHER INSURANCE**

The Company is a covered entity under a Financial Institution Bond in the name of XL America, Inc., the US holding company for XL Capital, Ltd. The policy provides a single loss limit of \$15,000,000 with a \$1,000,000 retention. The coverage meets the minimum amount of fidelity bond coverage recommended by the National Association of Insurance Commissioners for the Company and the other named insureds. Other insurance coverage covering the Company appeared adequate.

### **PENSION AND INSURANCE PLANS**

The Company has no direct employees. Qualified full-time employees of XL America, Inc. are provided with life insurance, accidental death and dismemberment, short and long-term disability, dental and vision benefits, and comprehensive medical expense benefits.

XL America, Inc. offers its employees a tax qualified noncontributory defined benefit retirement plan.

## STATUTORY DEPOSITS

The Company maintained the following deposits at December 31, 2002:

Location	Type of Asset	Statement Value	Market Value
Arkansas	US Treasury Notes	\$ 100,116	\$ 101,469
Arkansas	US Treasury Note	28,522	32,539
Louisiana	Certificate of Deposit	100,000	100,000
Louisiana	US Treasury Note	71,551	74,203
Massachusetts	US Treasury Note	939,829	1,004,063
New Mexico	US Treasury Bond	250,997	286,344
New York	US Treasury Note	3,102,724	3,221,250
North Dakota	US Treasury Notes	3,311,551	3,533,564
Oklahoma	US Treasury Bond	429,307	445,219
South Carolina	US Treasury Bond	176,839	201,742

The statement value of securities held in a custodial account and vested in the Commissioner of Insurance of the State of North Dakota for the benefit of all policyholders totaled \$3,311,551.

## INSURANCE PRODUCTS AND RELATED PRACTICES

At December 31, 2002, the Company was licensed only in the State of North Dakota and was an authorized surplus lines company in 47 states, the District of Columbia, Puerto Rico, Bermuda and Cypress writing primarily environmental liability and professional liability coverages.

The Company produces its business through a variety of sources including Managing General Agents (MGA). At year-end 2002, two general agents qualified as an MGA under the provisions of N.D. Cent. Code § 26.1-26.3-01(3) by producing premium volume in excess of five percent of the Company's prior year surplus and performing both underwriting and claims settlement for the Company.

During the period under examination, the examiner noted the following violations of N.D. Cent. Code Chapter 26.1-26.3, which governs transactions with a Managing General Agent:

- The Company utilized two agents who qualify as an MGA, one of which was not licensed as either a resident or nonresident insurance producer in North Dakota. N.D. Cent. Code § 26.1-26.3-02(2).
- The MGA agreements do not contain required provisions stating that all funds collected for the account of an insurer will be held by the managing general agent in a fiduciary capacity in a bank which is a member of the federal reserve system; that this account must be used for all payments on behalf of the insurer; and that the managing general agent may retain no more than three months estimated claims payments and allocated loss adjustment expenses. The agreements also do not specify the maximum premium volume that may be written by the MGA. N.D. Cent Code § 26.1-26.3-03(3) and (6).
- The Company did not notify the Commissioner within 30 days after performing a review of its books and records each quarter to determine if any of its agents have become, by

operation of N.D. Cent. Code § 26.1-26.3-01(3), a managing general agent as defined in that section. N.D. Cent. Code § 26.1-26.3-04(6).

- The Company conducted annual reviews of the underwriting and claims processing operations of the two agents who qualified as MGAs but not in compliance with the semiannual requirement specified N.D. Cent. Code § 26.1-26.3-04(3).

It was also noted that the business produced by one of the MGAs was not disclosed in Footnote 25 in the Notes to Financial Statements in the Company's Annual Statement as required by the *Annual Statement Instructions*.

**It is recommended that the Company comply with strict adherence to the requirements of N.D. Cent. Code Chapter 26.1-26.3.**

The Company also has a program administrator agreement with Automobile Protection Corporation (APCO). The agreement provides APCO with underwriting and claims authority for vehicle service contracts underwritten by the Company. The business written by APCO in 2002 represented approximately 5 percent of the Company's direct business.

During the course of this examination, a review was made of the manner in which the Company conducts its business practices and fulfills its contractual obligations to policyholders and claimants. This review was general in nature and substantially less in scope than a full scope market conduct examination. This review was directed at business practices in the following major areas: advertising, underwriting procedures and claims. No exceptions were noted.

## **REINSURANCE**

### **Ceded - Affiliate**

Under a quota share treaty effective April 1, 2001, the Company cedes 90% of its weather insurance risk business to affiliate XL Insurance Company of New York. Cessions under this agreement were 6% of total reinsurance premiums ceded in 2001 and 0% in 2002.

Through June 30, 1999, the Company ceded 85% of its business to its parent, XL Reinsurance America, Inc., under a quota share agreement which was effective January 1, 1994.

Effective July 1, 1999, the Company entered into the XL America Intercompany Pooling Agreement with XL Reinsurance America, Inc., the Company's direct parent, and three other affiliated companies. The Company ceded 100% of its direct written business after specific reinsurance to the pool and assumed 5% of the net-pooled amount. The pooling agreement was then amended on January 1, 2002, to be on a gross basis and then amended again effective December 31, 2002, to reflect the addition of two more affiliated companies:

- XL Insurance America, Inc. (formerly Winterthur International America Insurance Company) and
- XL Select Insurance Company (formerly known as Winterthur International America Underwriters Insurance Company).

The members of the pool are all U.S. based insurers and their pool participation percentages at December 31, 2002, are as follows:

NAIC Code	Company	State of Domicile	Pool Participation
20583	XL Reinsurance America, Inc. (formerly NAC Reinsurance Corp.)	NY	76%
22322	Greenwich Insurance Company	DE (formerly CA)	4%
36940	Indian Harbor Insurance Company	ND	2%
40193	XL Insurance Company of New York	NY	2%
37885	XL Specialty Insurance Company	DE (formerly IL)	6%
24554	XL Insurance America, Inc. (Formerly Winterthur International America Insurance Company)	DE (formerly WI )	8%
19607	XL Select Insurance Company	OK	2%

The pooling agreement may be terminated at any time with 90 days prior written notice or otherwise by mutual agreement. The agreement also contains an insolvency clause as required by N.D. Cent. Code § 26.1-02-21.

## ACCOUNTS AND RECORDS

The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the course of the examination and a trial balance as of December 31, 2002, was extracted from the general ledger and traced to the appropriate schedules of the Company's 2002 Annual Statement. The Company's ledgers are maintained electronically. Revenues and expenses were test checked to the extent deemed necessary.

The following deficiencies were noted during the examination:

- The Company uses general agents, managing general agents, and third-party administrators in the production of its business. The Company receives either monthly or quarterly reports from some of these producers in the aggregate with the net either payable to or receivable from the Company shown on the report. The aggregate reports do not include details by policy or claim. It was not possible to reconcile premium and loss detail to the Company's general ledger or filed annual statements. **It is recommended that the Company comply with statutory requirements and develop systems to maintain detailed premium and loss information and to reconcile all monthly reports from agents and administrators to the Company's general ledger.**
- The Company uses affiliate ECS, Inc. to manage its environmental program. As the program manager, ECS, Inc. produces business and settles losses on behalf of the Company; however, it does not report detailed premium and loss data to the Company. The Company does not properly account for the premium and loss payables in its general ledger or annual statement. The receivable/payable amounts resulting from the business produced by ECS, Inc. are recorded in the Payable to Parent, Subsidiaries and Affiliates account. This account is not settled on a timely basis. Recording the net balance of premiums and losses in this account results in a misstatement of loss and loss adjustment expenses payable, premium in course of collection and the related non-admitted portion of that asset. No examination change has been made in this report of

examination because it is not possible to quantify or examine the accounts from records in possession of the Company. **It is recommended that the Company obtain policy level detail for business produced through ECS, Inc. and that the resulting receivables and payables be reported in the proper annual statement account rather than netting the amounts into the intercompany receivable line. The intercompany balances should also be settled in accordance with the Services Agreement which specifies that settlements occur monthly.**

The Company is audited annually by an outside firm of independent certified public accountants. The work papers of this firm were made available to the Examiners and were used to the extent deemed appropriate for this examination.

## **FINANCIAL STATEMENTS**

The following pages present a Statement of Assets, Liabilities, Surplus, and Other Funds as of December 31, 2002. This statement is followed by supporting statements and reconciliations presented in the following order:

Statement of Assets, Liabilities, Surplus, and Other Funds, December 31, 2002

Underwriting and Investment Exhibit, Year 2002

Reconciliation of Capital and Surplus, December 31, 2000, through December 31, 2002



**Indian Harbor Insurance Company**  
**Statement of Assets**  
**as of December 31, 2002**

	<b><u>Ledger Assets</u></b>	<b><u>Assets Not Admitted</u></b>	<b><u>Net Admitted Assets</u></b>
Bonds	\$108,950,073		\$108,950,073
Cash and Short-Term Investments	38,048,985		38,048,985
Agents' Balances or Uncollected Premiums:			
Premiums and Agents' Balances In Course of Collection	7,835,493	\$ 1,709,934	6,125,559
Premiums and Agents' Balances and Installments Booked but Deferred and Not Yet Due	4,954,435		4,954,435
Accrued Retrospective Premiums	272,760		272,760
Amounts Receivable Under High Deductible Policies	49,865	5,457	44,408
Federal and Foreign Tax Recoverable and Interest Thereon	4,595,519	3,387,568	1,207,951
Guaranty Funds Receivable	259,867		259,867
Interest, Dividends, and Real Estate Income Due and Accrued	1,227,816		1,227,816
Receivable from Parent, Subsidiaries and Affiliates	25,967,586	74,101	25,893,485
Aggregate Write-ins for Other Than Invested Assets	<u>802,063</u>	<u>          </u>	<u>802,063</u>
Totals	<u>\$192,964,462</u>	<u>\$ 5,177,060</u>	<u>\$187,787,402</u>

**Indian Harbor Insurance Company**  
**Statement of Liabilities, Surplus and Other Funds**  
**as of December 31, 2002**

Losses		\$ 32,518,616
Reinsurance Payable on Paid Loss and Loss Adjustment Expenses		4,439,856
Loss Adjustment Expenses		3,111,527
Commissions Payable		1,153,180
Other Expenses		716,172
Taxes, Licenses and Fees		438,763
Federal and Foreign Income Taxes		0
Unearned Premiums		5,303,535
Advance Premiums		977,217
Funds Held by Company Under Reinsurance Treaties		95,315,034
Remittances and Items Not Allocated		6,221,054
Provision for Reinsurance		3,905,193
Drafts Outstanding		969,749
Payable to Parent, Subsidiaries, and Affiliates		29,633,832
Payable for Securities		1,329,850
Aggregate Write-ins for Liabilities		<u>2,287</u>
Total Liabilities		\$ 186,035,865
Common Capital Stock	\$ 5,000,000	
Gross Paid in and Contributed Surplus	31,000,000	
Unassigned Surplus	<u>(34,248,463)</u>	
Surplus as Regards Policyholders		<u>1,751,537</u>
Total		<u>\$187,787,402</u>

**Indian Harbor Insurance Company  
Underwriting and Investment Exhibit  
for the Year Ended December 31, 2002**

**Underwriting Income**

Premiums Earned		\$ 22,222,792
Deductions:		
Losses Incurred	\$18,453,873	
Loss Expenses Incurred	3,384,185	
Other Underwriting Expenses Incurred	<u>3,638,495</u>	
Total Underwriting Deductions		<u>25,476,553</u>
Net Underwriting Gain or (Loss)		\$ (3,253,761)

**Investment Income**

Net Investment Income Earned	\$ 3,382,896	
Net Realized Capital Gains or (Losses)	<u>1,380,666</u>	
Net Investment Gain or (Loss)		<u>4,763,562</u>
Net Income Before Federal Income Taxes		\$ 1,509,801
Federal Income Taxes Incurred		<u>(4,392,536)</u>
Net Income		<u>\$ 5,902,337</u>

**Indian Harbor Insurance Company**  
**Reconciliation of Capital and Surplus Accounts**  
**Year Ended December 31, 2002**

	<u><b>2000</b></u>	<u><b>2001</b></u>	<u><b>2002</b></u>
Capital and Surplus, December 31, Previous Year	\$21,909,468	\$25,058,321	\$ 20,708,402
Net Income	\$ (4,150,531)	\$ (6,390,859)	\$ 5,902,337
Change in Net Unrealized Capital Gains (Losses)	0	(76,362)	(39,892)
Change in Deferred Income Tax	0	219,928	2,988,396
Change in Non-admitted Assets	33,384	(741,113)	(1,886,215)
Change in Provision for Reinsurance	266,000	(146,000)	(2,518,725)
Cumulative Effect of Changes in Accounting Principles	0	(215,513)	(1,050,715)
Cumulative Effect of Examination Changes Capital Paid In	0	0	(28,351,359)
Surplus Paid In	7,000,000	3,000,000	6,000,000
Aggregate Write-ins for Gains/Losses in Surplus	0	0	(692)
Net Change in Capital and Surplus for the Year	<u>3,148,853</u>	<u>(4,349,919)</u>	<u>(18,956,865)</u>
Capital and Surplus, December 31, Current Year	<u>\$25,058,321</u>	<u>\$20,708,402</u>	<u>\$ 1,751,537</u>

**Indian Harbor Insurance Company  
Analysis of Examination Changes  
Year Ended December 31, 2002**

Description	Annual Statement	Per Examination	Surplus Change	
			Increase	Decrease
<b><u>Assets:</u></b>				
Agents' Balances or Uncollected Premium	\$ 7,072,281	\$ 6,125,559	\$	\$ (946,722)
Aggregate Write-ins for Other Than Invested Assets	0	802,063	802,063	
<b><u>Liabilities:</u></b>				
Losses	\$ 22,638,678	\$ 32,518,616		\$ (9,879,938)
Loss Adjustment Expenses	2,336,465	3,111,527		(775,062)
FIT Payable	4,388,906	0	4,388,906	
Unearned Premium Reserve	5,392,535	5,303,535	89,000	
Funds Held by Company Under Reinsurance Treaties	84,803,025	95,315,034		(10,512,009)
Remittances and Items Not Allocated	0	6,221,054		(6,221,054)
Provision for Reinsurance	3,313,725	3,905,193		(591,468)
Payable to Parent, Subsidiaries and Affiliates	<u>24,983,757</u>	<u>29,633,832</u>		<u>(4,650,075)</u>
Total Examination Adjustments			<u>\$ 5,279,969</u>	<u>\$ (33,576,328)</u>
Capital and Surplus Per Annual Statement		\$ 30,047,896		
Capital and Surplus Per Examination		<u>1,751,537</u>		
Decrease Per Examination		<u>\$ 28,296,359</u>		

## COMMENTS ON FINANCIAL STATEMENTS

### Cash

The Company reports amounts held in the Dreyfus Cash Management Fund, the One Group Institutional Prime Money Market Fund and the Fidelity Institutional Money Market Fund as part of Cash. These funds are Class 1 Funds listed in Section 9 of the *SVO Purposes and Procedures Manual* and should be reported in Schedule DA as Short-Term Investments

**It is recommended that the Company report money market fund balances in accord with the *Purposes and Procedures Manual of the SVO*.**

### Agent's Balances

The amount per examination is \$946,722 less than the \$7,072,281 reported by the Company. The difference is due to the adjustment of agents' balances over 90 days past due. The Company records certain accounts on a summary basis and then uses the accounting due date to determine whether the underlying policies are over 90 days past due. The Company also records credit over 90 day amounts and other offsetting such as reinsurance balances payable.

**It is recommended that the Company calculate agents' balances over 90 days past due in accordance with SSAP No. 6 of the *NAIC Accounting Practices and Procedures Manual*.**

The Company writes worker's compensation and aviation policies whose premiums are payable on an installment basis but these policies are not properly classified and reported as Installment Premiums Booked and Deferred but Not Yet Due on page 2, line 10.2 of the annual statement. No adjustment has been made because the amount of due and deferred premiums improperly reported as in course of collection could not be determined.

**It is recommended that the Company report installment premiums that have been booked but are not yet due on page 2, line 10.2, of the annual statement in compliance with the *Annual Statement Instructions*.**

### Aggregate Write-ins for Other Than Invested Assets

The amount per examination is \$802,063 more that reported by the Company. The increase is due to the reclassification of amounts forwarded by the Company to fund the initial loss funding of claims accounts for certain third party administrators.

### Losses and Loss Adjustment Expenses

During the third and fourth quarters of 2003, XL Reinsurance America, Inc. (XLRA) conducted a study of loss and loss adjustment expense reserves for certain lines of business for accident years 1997-2000. As a result of that study, gross loss reserves and loss adjustment expense reserves of XLRA were increased during the third and fourth quarters of 2003 with an additional increase in 2004.

As of December 31, 2004, XLRA has recorded adverse development of \$531,045,000 (net of reinsurance) for December 31, 2002 and prior years that is subject to the XL America Group Pooling Agreement. For purposes of this examination, this two-year development and a supporting actuarial review performed by the New York Insurance Department has been utilized to determine the Company's aggregate loss and loss adjustment reserves deficiency.

The Company's share of the loss and loss adjustment expense reserve development pursuant to the XL America Group Pooling Agreement is \$10,621,000. This amount, along with a minor adjustment for the inclusion of the Company's weather premiums in the XLRA quota share reinsurance agreement with XL Re Ltd, comprises the examination change increasing this liability by \$10,655,000.

### **FIT Payable**

The examination amount is \$4,388,906 less than reported by the Company. The reported FIT payable represented the accrual for the Company's 1999 estimated pro-forma federal income tax. The actual pro-forma federal income tax of \$4,650,075 was wire transferred to the Company's parent on June 20, 2000.

### **Unearned Premium Reserve**

The examination amount is \$89,000 less than reported by the Company. The decrease is to adjust for the inclusion of the Company's weather premiums in the XLRA quota share reinsurance agreement with XL Re Ltd.

### **Funds Held by Company Under Reinsurance Treaties**

The examination amount is \$10,512,009 more than that reported by the Company. The Funds Held account was adjusted at December 31, 2002, for the following:

- \$802,063 increase relating to the reclassification of initial funding of claims accounts,
- \$6,221,054 decrease relating to the reclassification of premium balances collected for XL Programs after the cut-off date to Remittances and Items not Allocated, and
- \$15,931,000 increase for amounts due to pool leader as a result of the increase in Loss Reserves for 2002.

### **Remittances and Items Not Allocated**

The examination amount is \$6,221,054 more than that reported by the Company. The account was increased relating to the reclassification of premium balances collected for XL Programs after the cut-off date that were incorrectly included in the Funds Held account.

### **Provision for Reinsurance**

The examination amount is \$591,468 more than the \$3,313,725 reported by the Company. The increase represents the Company's pro-rata share of unauthorized reinsurance to reinsurers who were listed as authorized by the Company that were found to be unauthorized as determined by the New York Insurance Department.

### **Payable to Parent, Subsidiaries and Affiliates**

The examination amount is \$4,650,075 more than reported by the Company. The increase represents actual pro-forma federal income tax of \$4,650,075 which was wire transferred to the Company's parent on June 20, 2000. The FIT payable account was not reduced to reflect the payment.

### **Surplus as Regards Policyholders**

The amount per examination is \$28,296,359 less than the \$30,047,896 reported by the Company, comprising a 94% decrease that is primarily due to a \$10,621,000 deficiency of loss and loss adjustment reserves and a related \$15,931,000 understatement of the Funds Held liability. If the Company's financial position at December 31, 2002, had included these deficient amounts, the resulting \$1.7 million surplus balance would have triggered a mandatory control action event under the risk-based capital provisions of N.D. Cent. Code Chapter 26.1-03.1.

This examination reviewed the Company's recovery of surplus at year-end 2003 in light of the examination adjustments made herein and the change in the Company's pool participation percentage from 5% to 2% effective December 31, 2002, under the amended pooling agreement noted under the Reinsurance section above. The following items served to increase the Company's surplus balance to \$32 million at December 31, 2003:

Surplus as Regards Policyholder at 12/31/2002 per exam	\$ 1.7 M
2003 Underwriting Gain (excluding reserve development)	4.1 M
Net Investment Gain	6.8 M
Other Income less Tax Provision	(0.5) M
Change in Reinsurance Provision/Other	2.5 M
Funds Held reversal **	15.9 M
Impact of non-reserve examination adjustments	1.7 M
Miscellaneous and rounding	0.1 M
Surplus as Regards Policyholders at 12/31/2003	\$32.3 M

- \*\* The Funds Held adjustment is imputed at December 31, 2002, but does not roll forward to December 31, 2003. This retrospective adjustment is due to the addition of two new pool members (XL Insurance America, Inc. and its wholly-owned subsidiary, XL Select Insurance Company) on December 31, 2002, who share in the pool's reserve increase for balance sheet purposes but not for income statement purposes. The actual entries for the reserve increase that were booked by the pool members in 2003 did not require a Funds Held adjustment.



## CONCLUSION

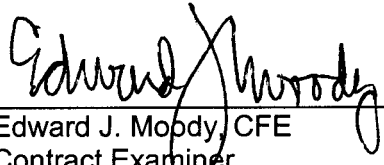
The financial condition of the Company, as of December 31, 2002, as determined by this examination is summarized as follows:

Admitted Assets	<u>\$187,787,402</u>
Total Liabilities	\$ 186,035,865
Surplus as Regards Policyholders	<u>1,751,537</u>
Liabilities, Surplus, and Other Funds	<u>\$187,787,402</u>

Since the last examination conducted as of December 31, 1999, the Company's admitted assets have increased \$83,175,187, its total liabilities have increased \$93,317,195, and its surplus as regards policyholders has decreased \$10,142,007.

The courteous cooperation extended by the officers and employees of the Company during the course of the examination is gratefully acknowledged.

Respectfully submitted,

  
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Edward J. Moody, CFE  
Contract Examiner  
N.D. Insurance Department

## COMMENTS AND RECOMMENDATIONS

- Page 8      It is recommended that the allocating entities comply with the Amended General Services Agreement and provide the detail reports as specified on a quarterly basis and that settlements of the charges occur 30 days thereafter.
- Page 11     It is recommended that the Company comply with strict adherence to the requirements for Managing General Agents as provided in N.D. Cent. Code Chapter 26.1-26.3.
- Page 12     It is recommended that the Company comply with statutory requirements and develop systems to maintain detailed premium and loss information and reconcile all monthly reports from agents and administrators to the Company's general ledger.
- Page 13     It is recommended that the Company obtain policy level detail for business produced through ECS, Inc. It is also recommended that the resulting receivables and payables be reported in the proper annual statement account rather than netting the amounts into the intercompany receivable line. The intercompany balances should also be settled monthly in accordance with the Services Agreement
- Page 19     It is recommended that the Company report money market fund balances in accord with the *Purposes and Procedures Manual of the SVO*.
- Page 19     It is recommended that the Company calculate agents' balances over 90 days past due in accordance with SSAP No. 6 of the *NAIC Accounting Practices and Procedures Manual*.
- Page 19     It is recommended that the Company report installment premiums that have been booked but are not yet due on page 2, line 10.2, of the annual statement in compliance with the *Annual Statement Instructions*.

## **SUBSEQUENT EVENTS**

On June 30, 2003, XL Reinsurance America, Inc., the Company's immediate parent, contributed all the outstanding shares of the Company to XL Specialty Insurance Company.

On July 7, 2005, XL Capital Ltd. announced a \$191 million pre-tax reserve increase in its North America operations that will be charged to its second quarter 2005 results. The Company's share of the net reserve increase under the XL America Group Pooling Agreement is \$768,000, of which \$640,000 or 83% is related to pre-2003 underwriting years. The reserve increase is equal to 2% of the Company's Surplus as Regards Policyholders and of carried Loss and LAE reserves as of December 31, 2004.